

SPECIAL FEATURES: THE CARIBBEAN

Puerto Rico as an Offshore Banking Center: A Discussion of the Puerto Rico "International Banking Center Regulatory Act"

MANUEL R. PIETRANTONI*
JOSÉ RAMÓN GONZÁLEZ

I. Introduction

The recent emphasis placed by the government of the Commonwealth of Puerto Rico on the development of service industries led to the enactment in 1980 of the International Banking Center Regulatory Act¹ (the "Act"). The Act was designed to create a tax and regulatory environment which would permit Puerto Rico to become an offshore banking center like Panama, the Bahamas, and the Cayman Islands, by attracting the establishment of new banks and bank branches, called "International Banking Entities" (IBE) in the Act. This article discusses the benefits and legal aspects involved in organizing and operating an IBE in Puerto Rico.

II. The Benefits of Establishing an IBE

An IBE established in Puerto Rico enjoys the same benefits that have distinguished the principal offshore banking centers of the world. These consist of:

1. *Inapplicability of Exchange Control Restrictions.* An IBE is allowed to use any currency in its borrowing and lending activities.²

2. *Low Taxation.* An IBE is eligible to enjoy a fifty percent exemption from Puerto Rico income taxes and a full exemption from Puerto Rico

*Mr. Pietrantonio and Mr. González practice law in San Juan, Puerto Rico.

¹International Banking Center Regulatory Act, Law No. 16 of July 2, 1980, *codified principally in* P.R. LAWS ANN. tit. 7, § 231 *et seq.* (Supp. 1981). All citations herein are to the Spanish language collection of P.R. LAWS ANN. Up to date supplements for the English language collection are not available.

²*Id.* § 15(a)(9), P.R. LAWS ANN. tit. 7, § 231n(a)(9) (Supp. 1981).

municipal license taxes for a ten year period.³ It also enjoys full exemption from the franchise tax imposed on financial institutions⁴ and property taxes.⁵

3. *No Withholding Taxes.* Interest on deposits paid by an IBE to a foreign person⁶ who is not engaged in a Puerto Rico business is exempt from Puerto Rico income taxes.⁷ The interest or finance charge paid by an IBE with respect to money borrowed from a foreign person, whether or not such person is engaged in a Puerto Rico trade or business, is also exempt.⁸

4. *No Deposit Reserve Requirement.* An IBE is not required to maintain any reserves with respect to its deposits.⁹

5. *No Interest Rate Limitation.* The interest payable by an IBE with respect to loans or deposits is not subject to any ceiling or regulation nor is

³Pursuant to § 32 of the International Banking Center Regulatory Act, P.R. LAWS ANN. tit. 13, § 255a(o)(23) (Supp. 1981), an IBE is eligible to obtain a grant of partial tax exemption under the Industrial Incentives Act of 1978, P.R. LAWS ANN. tit. 13, § 255 *et seq.* (Supp. 1981). The exemption period for an exempted business located in San Juan is ten years.

⁴International Banking Center Regulatory Act, § 26, P.R. LAWS ANN. tit. 7, § 1173. (Supp. 1981).

⁵*Id.* § 27, P.R. LAWS ANN. tit. 13, § 551(u) (Supp. 1981).

⁶The term "foreign person" as used in this section of the article refers to any corporation or partnership organized outside of Puerto Rico and any individual who is not a resident of Puerto Rico. Note, however, that the term "foreign person" is defined differently for purposes of the Act. See International Banking Center Regulatory Act, § 2(c), P.R. LAWS ANN. tit. 7, § 231a(c) (Supp. 1981); see also *infra*, note 39.

⁷P.R. LAWS ANN. tit. 13, § 3119(a)(1)(A) (1976), provides that interest on deposits with persons carrying on a banking business that is paid to persons not engaged in business within Puerto Rico is considered non-Puerto Rico source income. As non-Puerto Rico source income, any such interest paid to a foreign (non-Puerto Rico) corporation or partnership or a nonresident individual is exempt from Puerto Rico taxes. See P.R. LAWS ANN. tit. 13, §§ 3116(a)(1), 3211, 3212, 3231(c) (1976); P.R. RULES AND REGS. tit. 13, § 3011-2 (1959). Interest paid to a nonresident alien engaged in a Puerto Rico trade or business would be Puerto Rico source income subject to the normal tax and surtax imposed on resident individuals and subject to a withholding tax of twenty-nine percent. Interest paid to a foreign corporation engaged in a Puerto Rico trade or business, however, is not subject to withholding but is subject to the normal tax and surtax applicable to domestic corporations.

⁸Sections 28, 29, 30 and 31 of the International Banking Center Regulatory Act amended P.R. LAWS ANN. tit. 13, §§ 3119(a)(1), 3143(a), 3211(a)(1), and 3231 (Supp. 1981), to provide that such interest and finance charges would not be treated as income from Puerto Rico sources and would not be subject to Puerto Rico income tax.

⁹International Banking Center Regulatory Act, § 5, P.R. LAWS ANN. tit. 7, § 231d (Supp. 1981), provides that the International Banking Center Regulatory Board (hereinafter referred to as the "Board"), which was created by the Act to supervise and regulate the operations of IBEs, may not require the maintenance of any reserves on deposits. Also, § 24 of the Act, P.R. LAWS ANN. tit. 7, § 231w (Supp. 1981), provides that the Puerto Rico Banking Law, as amended, P.R. LAWS ANN. tit. 7, § 1, *et seq.* (1963 & Supps. 1980, 1981), under which the local regulatory authorities could impose a reserve requirement, does not apply to IBEs (except for certain limited emergency provisions discussed later). Article 5 of the proposed regulations which have been drafted to implement the provisions of the Act [hereinafter cited as Proposed Regulations] provides further that an IBE is not subject to the reserve requirements applicable to banks under the Puerto Rico Banking Law.

The Proposed Regulations of the Board have not as yet been adopted nor published. The authors obtained unofficial copies from the Puerto Rico Department of the Treasury, San Juan, Puerto Rico.

such interest subject to the local usury laws.¹⁰

6. *No Minimum Deposit.* No limitation is imposed with respect to the minimum amount of deposit acceptable by an IBE.

7. *Secrecy.* Although an IBE's books and accounts are not secret, neither the Act nor the Proposed Regulations require that an IBE include in its records the identity of its depositors.¹¹ Furthermore, the Proposed Regulations provide that any information obtained by the regulatory authorities through an investigation or report "shall be kept confidential and shall not be revealed to any person or authority other than in compliance with a lawfully issued judicial or administrative subpoena."¹²

8. *Inapplicability of Other Banking Regulations.* The provisions of the Puerto Rico Banking Law,¹³ which ordinarily apply to all banks licensed by the Puerto Rico regulatory authorities, do not apply to an IBE except for certain limited provisions dealing primarily with: (a) the power of the Governor to adopt special measures with respect to banking activities in case of an emergency (such as the occurrence of a natural disaster), or in case a bank lacks currency due to an abnormal withdrawal of deposits; and, (b) the power of the regulatory authorities to deal with a closed bank.¹⁴

III. Organizing and Operating an IBE—Regulations under Puerto Rico Law

The principal regulatory authority in Puerto Rico to which responsibility for the organization and operation of IBEs has been delegated is the International Banking Center Regulatory Board (the "Board"). The Board is composed of two members selected from the public sector and one member appointed by the Governor from the private sector. Although it is empowered to carry out all regulatory functions with respect to IBEs, the Board was specifically denied the authority to impose ceilings on the interest payable on deposits and deposit reserve requirements.¹⁵

A. Licensing Requirements

Any person, including an individual, business organization or government entity,¹⁶ may file an application with the Board for approval to organize an IBE.¹⁷

¹⁰International Banking Center Regulatory Act, § 5, P.R. LAWS ANN. tit. 7, § 231d (Supp. 1981), provides that the Board may not establish interest rates to be charged by, or paid to, an IBE. Moreover, § 24 of the Act, P.R. LAWS ANN. tit. 7, § 231w (Supp. 1981), exempts IBEs from the interest rate limitations imposed by Puerto Rico's usury laws. See also Proposed Regulations, *supra* note 9, Art. 5.

¹¹Proposed Regulations, *supra* note 9, Art. 9(a)(1).

¹²*Id.* Art. 10.

¹³P.R. LAWS ANN. tit. 7, § 1 *et seq.* (1963 & Supps. 1980, 1981).

¹⁴International Banking Center Regulatory Act, § 24, P.R. LAWS ANN. tit. 7, § 231w (Supp. 1981), and Proposed Regulations, *supra* note 9, Art. 13.

¹⁵International Banking Center Regulatory Act, § 5, P.R. LAWS ANN. tit. 7, § 231d (Supp. 1981).

¹⁶*Id.* § 2(g), P.R. LAWS ANN. tit. 7, § 231a(g) (Supp. 1981).

¹⁷*Id.* § 9(a), P.R. LAWS ANN. tit. 7, § 231h(a) (Supp. 1981).

An IBE must be established either as a corporation organized under the laws of Puerto Rico, the laws of the United States or the laws of a state of the United States, or as a "unit" of any such corporation.¹⁸ A "unit" is defined as any subdivision or branch of a corporation whose business and operations are segregated from the other business and operations of such corporation.¹⁹

An IBE which is organized as a corporation, or the corporation of which the IBE is a unit, must have an authorized capital stock of at least five million dollars.²⁰ The actual paid-in capital required, however, or the value of the assets which must be assigned to an IBE operating as a unit, is only three hundred thousand dollars.²¹

An application for approval to organize an IBE must be accompanied by audited annual financial statements of the applicant and any parent entity²² and, if applicable, its proposed articles of incorporation.²³ The application must also include:²⁴

- a) Information regarding the financial condition of the applicant, its parent entity, and any other person who will own five percent or more of the shares of any class of voting stock of the IBE or of the parent entity;
- b) Information regarding the business experience of the persons who will be responsible for the management of the IBE;
- c) Plans for the capitalization of the IBE;
- d) Plans for the staffing of the IBE;
- e) Activities to be conducted by the IBE; and,
- f) The intention of the applicant to shift to the IBE any existing banking or financial activity conducted by the applicant or parent entity.

¹⁸*Id.* § 8(a), P.R. LAWS ANN. tit. 7, § 231g(a) (Supp. 1981).

¹⁹*Id.* § 2(f), P.R. LAWS ANN. tit. 7, § 231a(f) (Supp. 1981).

²⁰*Id.* § 8(b)(3), P.R. LAWS ANN. tit. 7, § 231g(b)(3) (Supp. 1981).

²¹*Id.* § 13(a), P.R. LAWS ANN. tit. 7, § 231k(a) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 6(d)(3).

²²Proposed Regulations, *supra* note 9, Art. 6(d)(2). "Parent entity" is defined by the Proposed Regulations as an organization or group of persons that holds, directly or indirectly, 50% or more of the voting stock of an IBE or of an applicant for an IBE license, or which otherwise controls such IBE or applicant, and includes "each organization superior to the IBE on the hierarchy of a corporate organization which holds, directly or indirectly, 50% or more of the equity interest of the organization below it." In the case of an IBE which is a branch or a subsidiary of a bank which is owned by a bank holding company, as defined under § 2(a) of the United States Bank Holding Company Act of 1956, *as amended*, 12 U.S.C.A. § 1841(a) (West 1980), the term "parent entity" would not include such bank holding company. Proposed Regulations, *supra* note 9, Art. 4(j).

²³If the IBE is to be a unit rather than a corporation, the application must be accompanied by a certificate approved by the Board of Directors of the corporation of which the IBE is to be a unit setting forth information analogous to that contained in articles of incorporation of a corporation. International Banking Center Regulatory Act, § 8(c), P.R. LAWS ANN. tit. 7, § 231g(c) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 6(d)(2).

²⁴Proposed Regulations, *supra* note 9, Art. 6(d)(2).

Some of the factors which the Board is required to consider in reviewing an application for approval to organize an IBE include:²⁵

- a) The financial solvency, banking experience and business integrity of the applicant, its directors and officers;
- b) The adequacy of the proposed capitalization of the IBE or of the corporation of which it is to be a unit;
- c) The impact of the proposed operations of the IBE on the economy of Puerto Rico; and,
- d) The plans for staffing the IBE.

Once the Board is satisfied with the results of its investigation, it issues a permit to the applicant which specifies the requirements for the capitalization or assignment of assets to the IBE.²⁶ This permit enables the applicant to undertake the additional steps which are necessary to organize the IBE and obtain the license required to conduct banking operations.²⁷

To obtain this license, the applicant must file with the Board and with the Department of State of Puerto Rico various corporate documents, capitalize the IBE in accordance with the terms of its permit, and pay the fifty thousand dollars annual license fee.²⁸ When applicable, the applicant must also furnish to the Board evidence that the corporation of which the IBE is a unit has complied with all the requirements of regulatory agencies in its home jurisdiction with respect to the establishment of foreign branches or subsidiaries.²⁹ The license becomes effective once it is filed with the Puerto Rico Department of State.³⁰

An IBE's license may be revoked by the Board if the IBE elects treatment under Section 936 of the United States Internal Revenue Code of 1954,³¹ if the IBE or its parent entity violates any provision of the Act or regulations thereunder,³² if the business of the IBE is carried out in an unsound fashion or contrary to the public interest,³³ if the IBE is found to be insolvent,³⁴ or if the IBE fails to pay the annual license fee.³⁵

²⁵International Banking Center Regulatory Act, § 9(c), P.R. LAWS ANN. tit. 7, § 231h(c) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 6(d)(4).

²⁶Proposed Regulations, *supra* note 9, Art. 6(d)(5).

²⁷International Banking Center Regulatory Act, § 10, P.R. LAWS ANN. tit. 7, § 231i(b) (Supp. 1981).

²⁸*Id.* §§ 10(a), 18, P.R. LAWS ANN. tit. 7, §§ 231i(a), 231q (Supp. 1981).

²⁹Proposed Regulations, *supra* note 9, Art. 6(e)(3)(e).

³⁰*Id.* Art. 6(e)(4).

³¹*Id.* Art. 12(a).

³²International Banking Center Regulatory Act, § 20(a)(1), P.R. LAWS ANN. tit. 7, § 231s(a)(1) (Supp. 1981).

³³*Id.* § 20(a)(3), P.R. LAWS ANN. tit. 7, § 231s(a)(3) (Supp. 1981).

³⁴*Id.* § 20(a)(4), P.R. LAWS ANN. tit. 7, § 231s(a)(4) (Supp. 1981).

³⁵*Id.* § 20(a)(2), P.R. LAWS ANN. tit. 7, § 231s(a)(2) (Supp. 1981).

B. Operating Requirements

1. *General Requirements.* An IBE must establish a physical presence in Puerto Rico. It must obtain suitable office space and provide the Board with evidence of the same.³⁶ In the case of banks already established in Puerto Rico, these requirements can be fulfilled by setting aside a portion of the bank's existing office space.³⁷

2. *Permissible Activities.* An IBE is permitted to engage in the following activities (in dollars or foreign currencies):

a) Accept time deposits³⁸ or otherwise borrow money (other than through demand deposits) from any foreign person,³⁹ from any domestic or United States bank, trust company or savings and loan association, and from any other IBE;

b) Accept deposits or otherwise borrow money from the Government Development Bank for Puerto Rico;⁴⁰

c) Place deposits with any bank,⁴¹ with the Government Development

³⁶Proposed Regulations, *supra* note 9, Art. 6(b).

³⁷*Id.*

³⁸The terms "time deposit" and "fixed term deposit" appear to be used interchangeably in the Act and the Proposed Regulations to mean any deposit other than a demand deposit. A "demand deposit" is defined in the Proposed Regulations as a deposit which, from the time it is made, the depositor has the right to withdraw on demand. Proposed Regulations, *supra* note 9, Art. 4(d). A "time deposit" is defined in the Proposed Regulations as:

a deposit with respect to which there is in force a written contract with the depositor that neither the whole nor any part of such deposit may be withdrawn prior to the date of maturity. Time deposit includes a deposit payable (i) on a specified date at least one day after the date of deposit, (ii) at the expiration of a specified time at least one day after the day of deposit, or (iii) upon written notice which notice is actually required to be given at least one day before the date of repayment. A time deposit may be represented by a transferable instrument, a negotiable or non-negotiable instrument or otherwise.

Id. Art. 4(q).

³⁹The term "foreign person" is defined in the Act as any person other than a domestic person or a United States person. International Banking Center Regulatory Act, § 2(c), P.R. LAWS ANN. tit. 7, § 231a(c) (Supp. 1981). A "domestic person" is defined as an individual resident of Puerto Rico, a legal entity organized under the laws of Puerto Rico, a person whose principal place of business is located in Puerto Rico and the government of Puerto Rico (or any political subdivision thereof). *Id.* § 2(b), P.R. LAWS ANN. tit. 7, § 231a(b) (Supp. 1981). A "United States person" is defined as an individual resident of the United States, a legal entity organized under the laws of the United States, a person whose principal place of business is located in the United States and the government of the United States (or any subdivision thereof). *Id.* § 2(j), P.R. LAWS ANN. tit. 7, § 231a(j) (Supp. 1981). A "resident of Puerto Rico" (the term "resident of the United States" is not defined in the Act or the Proposed Regulations) is defined as:

any person who establishes himself in Puerto Rico with a definite purpose or interest, the nature of which requires a lengthy stay on the Island. . . . Such person must make Puerto Rico his home temporarily, even when his intention is to return to his domicile outside of Puerto Rico after the purpose or interest that originally brought him to Puerto Rico has been terminated or abandoned." *Id.* § 2(k), P.R. LAWS ANN. tit. 7, § 231a(k) (Supp. 1981).

⁴⁰*Id.* § 15(a)(3), P.R. LAWS ANN. tit. 7, § 231n(a)(3) (Supp. 1981).

⁴¹*Id.* § 15(a)(4), P.R. LAWS ANN. tit. 7, § 231n(a)(4) (Supp. 1981), indicates that the term "any bank" includes any bank organized under the laws of Puerto Rico and any local branch of a bank that is a "foreign person" ("foreign person" as used in the International Banking Center Act would not include a United States bank). Article 7(a)(2)(c) of the Proposed Regulations eliminates any doubt as to the omission of branches of United States banks from the

Bank for Puerto Rico, or with another IBE;

d) Engage in any of the following lending activities provided all of the loan proceeds are used outside of Puerto Rico and the United States:⁴²

- i) Make, negotiate, place, guarantee, or service loans;
- ii) Issue, confirm or give notice of letters of credit; or,
- iii) Discount bills of exchange;

e) Invest in securities, stock or notes;⁴³

f) Participate in foreign exchange transactions;⁴⁴ and,

g) Engage in any activity incidental to the performance of the services authorized by the Act or the regulations thereunder and any other activity authorized by such regulations.⁴⁵

With regard to the types of deposit that may be accepted by an IBE, the Act provides that the only type of demand deposit that may be accepted is an interbank deposit.⁴⁶ The Proposed Regulations indicate that a time deposit accepted by an IBE may be negotiable or non-negotiable.⁴⁷

The Proposed Regulations elaborate further the scope of permissible activities for IBEs. Article 7 of the Proposed Regulations provides that they may:

a) Assume or acquire participations in extensions of credit,⁴⁸

b) Engage in repurchase arrangements involving foreign exchange, gold, silver, and securities that are the functional equivalent of extensions of credit,⁴⁹

c) Trade in gold and silver,⁵⁰ and

d) Hold, buy and sell securities for the account and risk of foreign persons.⁵¹

Article 7 of the Proposed Regulations also elaborates on the requirement that the proceeds of the lending activities be used outside Puerto Rico and the United States. It provides that the type of "qualified use" which meets the requirement of the Act includes using such proceeds to finance the exportation of goods from Puerto Rico or the United States to a destination outside these jurisdictions, or to finance the foreign portion of contracts, projects or activities to be performed wholly or substantially outside of Puerto Rico and the United States. It does not include using the proceeds to finance the importation of goods into Puerto Rico.

language of the statute by stating that "any bank" includes branches of banks that are "United States or foreign persons."

⁴²*Id.* §§ 15(a)(5), (6), (7), P.R. LAWS ANN. tit. 7, §§ 231n(a)(5), (6), (7) (Supp. 1981).

⁴³*Id.* § 15(a)(8), P.R. LAWS ANN. tit. 7, § 231n(a)(8) (Supp. 1981).

⁴⁴*Id.* § 15(a)(9), P.R. LAWS ANN. tit. 7, § 231n(a)(9) (Supp. 1981).

⁴⁵*Id.* §§ 15(a)(10), (11), P.R. LAWS ANN. tit. 7, §§ 231n(a)(10), (11) (Supp. 1981).

⁴⁶*Id.* § 15(a)(1), (2), P.R. LAWS ANN. tit. 7, § 231n(a)(1), (2) (Supp. 1981).

⁴⁷Proposed Regulations, *supra* note 9, Art. 4(q).

⁴⁸*Id.* Art. 7(a)(2)(d).

⁴⁹*Id.* Art. 7(a)(2)(g).

⁵⁰*Id.* Art. 7(a)(3).

⁵¹*Id.* Art. 7(a)(4)(b).

Article 7(a)(2) of the Proposed Regulations also provides that the "qualified use" requirement will be presumed satisfied if:

i) the recipient of the proceeds is a foreign entity (other than one in which more than fifty percent of the voting securities or equity interests are owned by United States or Puerto Rico persons) and the IBE has no notice of facts that would reasonably lead it to believe that the proceeds are for use within the United States or Puerto Rico; or,

ii) the recipient of the proceeds represents to the IBE that the proceeds are not to be used within the United States or Puerto Rico, and the IBE has no notice of facts that would reasonably lead it to believe that said representation is not true.

With respect to permissible investments in securities, Article 7(a)(4) of the Proposed Regulations provides that an IBE may:

a) Invest in securities of any government or governmental agency or in notes and obligations of banking institutions, provided the proceeds of the investments are used outside of Puerto Rico and the United States;⁵² and,

b) Make portfolio investments in companies, provided such investments represent less than ten percent of the total assets of the IBE and constitute ownership of less than ten percent of the total outstanding shares of voting stock of any such company.⁵³

3. *Prohibited Activities.* An IBE may not engage in any activity which is not included among the list of permissible activities enumerated in the Act, except as it may be incidental to the services the IBE is authorized to perform under the provisions of the Act and the regulations, or except as the IBE may have received authorization to engage in such additional activity by the Board.⁵⁴

The Proposed Regulations provide that an IBE cannot engage in transactions of any nature with United States corporations which have elected the benefits of Section 936 of the United States Internal Revenue Code of 1954, as amended, except banks or corporations that are not doing business in Puerto Rico.⁵⁵

4. *Capital.* Upon receiving its license and at all times thereafter, an IBE is required to maintain at least three hundred thousand dollars in unencumbered assets in Puerto Rico. These assets may consist of deposits with the

⁵²An exception is made for bonds and other obligations of Puerto Rico and the United States purchased by the IBE to comply with the requirement of having \$300,000 in unencumbered assets. See note 56 and accompanying text, *infra*.

⁵³The regulations provide, however, that an IBE may hold more than 10% of the total outstanding shares of voting stock of any company for a reasonable period of time if such shares were acquired as a result of a foreclosure of any loan or extension of credit for which such shares were held as collateral. Proposed Regulations, *supra* note 9, Art. 7(a)(4)(c).

⁵⁴ International Banking Center Act, §§ 15(a)(10),(11),(b), P.R. LAWS ANN. tit. 7, §§ 231n(a)(10),(11),(b) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 7(b)(1).

⁵⁵Proposed Regulations, *supra* note 9, Art. 7(b)(2).

Government Development Bank for Puerto Rico or with other banks doing business in Puerto Rico (not including affiliates of the IBE), investments in Puerto Rico government securities, United States government securities and United States municipal securities, or any other real or personal property owned by the IBE and held in Puerto Rico.⁵⁶

5. *Changes Requiring Board Notification or Approval.* The capital structure of an IBE may not be altered without the prior written approval of the Board. This restriction applies to any reduction in capital and to any issuance of stock or other securities convertible into stock.⁵⁷ An IBE is also required to seek prior written approval from the Board for amendments to its articles of incorporation.⁵⁸

Transfers involving the sale of more than five percent of the outstanding shares of any class of voting securities of an IBE or more than ten percent of the outstanding shares of any class of non-voting securities, or transfers which cause any person to own more than five percent of the outstanding voting shares or ten percent of the non-voting shares require thirty days prior notice to the Board and written authorization.⁵⁹ Similar transfers involving the securities of the parent entity must also be reported to the Board within ten days after the occurrence of the transfer, but the Board's prior approval is not required.⁶⁰

A transfer of control would not result in revocation of an IBE's license unless the Board determined that the IBE's ability to conduct its operations and meet its obligations could be impaired, that the transfer would result in a violation of the Act or regulations, or that the transfer would have a negative impact on the economy of Puerto Rico.

6. *Reports and Records.* An IBE must maintain a complete set of books and records in its business office in Puerto Rico. Such records must be segregated from the records of any other affiliated enterprise.⁶¹ These records are subject to inspection by the Board.

An IBE must submit annual and quarterly financial statements to the Board.⁶² The annual statements, which must include a balance sheet and an income statement, must be certified by an independent certified public accountant licensed to practice in Puerto Rico.⁶³

7. *Personnel.* Within the course of its first year of operation an IBE must

⁵⁶International Banking Center Regulatory Act, § 12(a), P.R. LAWS ANN. tit. 7, § 231k(a) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 6(f).

⁵⁷International Banking Center Regulatory Act, § 12(b), (c), P.R. LAWS ANN. tit. 7, § 231k(b), (c) (Supp. 1981).

⁵⁸*Id.* § 11, P.R. LAWS ANN. tit. 7, § 231j (Supp. 1981).

⁵⁹*Id.* § 13(a), P.R. LAWS ANN. tit. 7, §§ 2311(a) (Supp. 1981).

⁶⁰Proposed Regulations, *supra* note 9, Art. 6(g)(1).

⁶¹*Id.* Art. 9(a)(2).

⁶²*Id.* Art. 9(b)(1), (2).

⁶³International Banking Center Regulatory Act, § 19, P.R. LAWS ANN. tit. 7, § 231r (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 9(b)(2).

employ in Puerto Rico at least six persons on a full-time basis.⁶⁴ Furthermore, during its first year of operation at least forty percent of its full-time employees must be residents of Puerto Rico, with such minimum rising in successive years until the fourth year, by which time all of its full-time employees must be residents of Puerto Rico.⁶⁵ For these purposes, employees of a corporation of which the IBE is a unit will be considered employees of the IBE only if such employees are assigned exclusively to the operations of the unit.⁶⁶

IV. Regulation of an IBE under United States Banking Law

The Commonwealth of Puerto Rico has traditionally been accorded great deference in matters pertaining to the regulation of depository institutions on the island. Under the United States banking statutes Puerto Rico is usually treated as if it were a foreign country, with the result that the federal banking statutes are generally inapplicable to financial institutions (including United States banks) doing business on the island.⁶⁷

As has been discussed, an IBE may be established either as a corporation organized under the laws of Puerto Rico or the United States, or as a branch or subdivision thereof.⁶⁸ An IBE which chooses to operate as a branch of a Puerto Rico or United States bank⁶⁹ is excluded from coverage of the Federal Reserve Board's regulations with respect to reserve require-

⁶⁴International Banking Center Regulatory Act, § 16(a), P.R. LAWS ANN. tit. 7, § 2310(a) (Supp. 1981); Proposed Regulations, *supra* note 9, Art. 11(a).

⁶⁵*Id.*

⁶⁶International Banking Center Regulatory Act, § 16(b), P.R. LAWS ANN. tit. 7, § 2310(b); Proposed Regulations, *supra* note 9, Art. 11(b). On this point the Proposed Regulations vary significantly from the requirements of the statute, since the regulations only require employees to be *principally* devoted to functions of the IBE.

⁶⁷*See, e.g.*, §§ 25 and 25(a) of the Federal Reserve Act, *as amended*, 12 U.S.C.A. §§ 601, 611 (West 1957 & Supp. 1981); § 1(b)(7) of the International Banking Act of 1978, 12 U.S.C.A. § 3101(7) (West 1980); Board of Governors of the Federal Reserve System, Reg. K, 12 C.F.R. § 211.2(f) (1980). *Cf.* § 2(3)(o) of the Federal Deposit Insurance Act, *as amended*, 12 U.S.C.A. § 1813(o) (West 1980) (Puerto Rico branches of insured banks defined as "domestic" branches for Federal Deposit Insurance Act purposes); § 2(c) of the Bank Holding Company Act of 1956, *as amended*, 12 U.S.C.A. § 1841(c) (West 1980) (Puerto Rico banks covered by provisions of the Bank Holding Company Act).

⁶⁸*Supra* note 18.

⁶⁹Members of the Federal Reserve System may establish branches in Puerto Rico with the approval of the Board of Governors of the System under § 25 of the Federal Reserve Act, *as amended*, 12 U.S.C.A. § 601 (West 1957 & Supp. 1981); *and see* Board of Governors of the Federal Reserve System, Reg. K, 12 C.F.R. § 211.3 (1980). Insured State nonmember banks may establish branches on the island with the approval of the Federal Deposit Insurance Corporation under § 2(18)(d) of the Federal Deposit Insurance Act, 12 U.S.C.A. § 1828(d) (West 1980); *and see* 12 C.F.R. § 303.2 (1980). In addition, a bank may need the approval of its home state banking authorities for opening such branch. Puerto Rico banks may establish branches with the approval of both the Commonwealth's Secretary of the Treasury, P.R. LAWS ANN. tit. 7, § 111(i) (Supp. 1980), and the Federal Deposit Insurance Corporation, if the bank is insured by the latter, 12 U.S.C.A. § 1828(d) (West 1980).

ments,⁷⁰ maximum interest payable on deposits⁷¹ and interstate branching limitations.⁷² An IBE which is organized as a Puerto Rico corporation⁷³ is similarly exempt.⁷⁴

An IBE organized as an Edge Act⁷⁵ corporation would not have any problems under the present federal regulatory framework.⁷⁶ An IBE which is organized under the laws of a state, however, may be subject to its home state's banking law and regulations and, consequently, may be restricted from functioning effectively as an IBE.⁷⁷

The regulatory changes recently adopted by the Federal Reserve Board to facilitate the establishment of "international banking facilities" in the United States⁷⁸ will not have any impact on the activities of IBEs in Puerto Rico. The Federal Reserve Board has amended its regulations to permit United States depository institutions, Edge Act corporations and United States branches of foreign banks to conduct international banking activities from their United States offices without being subject to reserve requirements and limitations with regard to the maximum rate of interest payable

⁷⁰This exemption would arise for all banks under § 103(b)(6) of the Monetary Control Act of 1980, 12 U.S.C.A. § 461(b)(6) (West 1980); *and see* Board of Governors of the Federal Reserve System, Reg. D, 12 C.F.R. § 204.1(c)(5) (1980).

⁷¹For member banks, this exemption arises under Regulation Q of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 217.0(d) (1980); for insured state nonmember banks, the exemption arises under 12 C.F.R. § 329.0 (1980).

⁷²*See* Board of Governors of the Federal Reserve System, Reg. K, 12 C.F.R. § 221.2(f); 12 C.F.R. 346.1(a) (1980); National Bank Act, *as amended*, 12 U.S.C.A. § 36 (West 1945 & Supp. 1981); International Banking Act of 1978, §§ 1(b)(7), (10), 12 U.S.C.A. § 3101(7), (10) (West 1980).

⁷³Such corporations may be organized, with the approval of the Board of Governors of the Federal Reserve System, by member banks under § 25 of the Federal Reserve Act, *as amended*, 12 U.S.C.A. § 601 (West 1957 & Supp. 1981), or by bank holding companies under § 3 of the Bank Holding Company Act of 1956, *as amended*, 12 U.S.C.A. § 1842 (West 1980). A foreign banking institution could also organize a Puerto Rico corporation if permitted by its home jurisdiction's regulations. Such organization, however, may require approval by the Board of Governors of the Federal Reserve System under Section 3 of the Bank Holding Company Act of 1956, *as amended*, 12 U.S.C.A. § 1842 (West 1980), because an IBE might be considered a "bank" under the definitions of the Bank Holding Company Act. Bank Holding Company Act of 1956, *as amended*, 2(c), 12 U.S.C.A. § 1841(c) (West 1980).

⁷⁴An IBE incorporated in Puerto Rico would be exempt from the Board's reserve requirement and interest on deposit regulations under the same rationale as set forth, *supra*, at notes 70-72.

⁷⁵12 U.S.C.A. §§ 611 *et seq.* (West 1957 & Supp. 1981).

⁷⁶Edge Act corporations are subject to reserve requirements and regulation of interest payable on deposits as if they were member banks. Board of Governors of the Federal Reserve System, Reg. K, 12 C.F.R. § 211.4(d) (1980). The provisions of the regulations which exclude from coverage deposits payable only outside the United States should, however, serve to exempt the deposits of IBEs organized as Edge Act corporations from those regulations. Board of Governors of the Federal Reserve System, Reg. D, 12 C.F.R. § 204.1(c)(5); *id.* Reg. Q, 12 C.F.R. § 217.0(d) (1980).

⁷⁷*See, e.g.*, the provisions of the Florida Banking Code, 1980 Fla. Sess. Law Serv. Ch. 80-260, which define the banking business as consisting essentially of receiving deposits. A Florida corporation which performs such services is probably subject to the provisions of the Florida Banking Code. 1980 Fla. Sess. Law Serv. Ch. 80-260, §§ 663.104(3), (12).

⁷⁸*See* 46 Fed. Reg. 32,426 (1981) (amending 12 C.F.R. pts. 204, 217).

on deposits.⁷⁹ Inasmuch as Puerto Rico is not considered part of the United States for purposes of these regulations,⁸⁰ the proposed changes will not add or detract from the favorable conditions now available for conducting international banking transactions in Puerto Rico.

V. Puerto Rico Income Taxation of an IBE and Its Shareholders

A. *An IBE Organized as a Puerto Rico Corporation or a Branch Thereof*

1. *Taxes on Income from Operations.* An IBE organized as a Puerto Rico corporation would normally be subject to Puerto Rico income tax on its worldwide income.⁸¹ Under Section 32 of the Act, however, an IBE is eligible to receive the benefits of partial tax exemption afforded by the provisions of the Puerto Rico Industrial Incentives Act of 1978 (the "Incentives Act").⁸² Pursuant to Section 3(o) of the Incentives Act, fifty percent of the net income earned by a "service unit" that has received a grant of tax exemption from the Governor of Puerto Rico is exempt from Puerto Rico income taxes during a specified exemption period, the length of which depends on where the exempted business is established. An exempted business established in San Juan, the capital city, is entitled to a ten-year exemption period.

To be eligible for the exemption, an IBE would have to qualify as a "service unit" and provide a "designated service." Every IBE would meet the second requirement since Section 32 of the Act amended the Incentives Act to specifically include the services rendered by an IBE as a "designated service." The first requirement, however, may be more difficult to satisfy.

A "service unit" is defined as: "a bona fide office, business or establishment . . . with the capacity and expertise needed to carry out the main functions involved in rendering a designated service on a commercial scale exclusively for markets outside Puerto Rico."⁸³ The definition also requires that eighty percent of the unit's employees (those who work in excess of twenty hours a week) reside in Puerto Rico, that at least eighty percent of the value of the unit's services be generated from sources in Puerto Rico, and that the unit's services not be used directly or indirectly in Puerto Rico.

This definition poses some significant and possibly contradictory differences between the operating requirements imposed on an IBE under the Act and those that an IBE would have to satisfy in order to qualify as a "service unit." Under the Incentives Act, eighty percent of the employees of an IBE must, at the outset, be residents of Puerto Rico whereas under the Act this requirement does not become operative until the third year of oper-

⁷⁹*Id.*

⁸⁰Board of Governors of the Federal Reserve System, Reg. D, 12 C.F.R. §§ 204.2(o), (r); *id.* Reg. Q, 12 C.F.R. §§ 217.0(d), 217.7, note 1 (1980).

⁸¹P.R. LAWS ANN. tit. 13, § 3022(a) (1976).

⁸²P.R. LAWS ANN. tit. 13, § 255 *et seq.* (Supp. 1981).

⁸³*Id.* § 255a(q) (Supp. 1981).

ation. The more significant difference, however, stems from the requirements imposed by the Incentives Act to the effect that the services provided by a service unit: (i) must be rendered exclusively for markets outside Puerto Rico; (ii) must not be used directly or indirectly in Puerto Rico; and, (iii) eighty percent of their value must be generated from sources in Puerto Rico.⁸⁴ Considering that the income producing activities of an IBE do not consist of rendering services but consist principally of accepting and lending deposits, it is not clear how these three requirements will be applied to the activities of an IBE. For instance, it is not clear whether some of an IBE's permitted activities, such as the acceptance of deposits from local banks, will be considered to violate the first two of these requirements. It is also not clear whether the loans made to nonresidents of Puerto Rico or the services provided by the IBE's home office or parent company located outside of Puerto Rico (such as lending the funds deposited with the IBE) will be considered to violate the third requirement.

Article 8 of the Proposed Regulations attempts to resolve these differences by providing that the activities in which an IBE is permitted to engage shall be deemed to satisfy all of the requirements for qualifying as a "service unit" and that all of the income generated by such activities shall be deemed to qualify for the exemption provided under the Incentive Act. It is not clear, however, whether these differences can be resolved adequately without supplementary legislation. It can be anticipated, nevertheless, that these conflicts will be resolved, at least administratively, in favor of permitting an IBE to qualify as a service unit.

An IBE that qualifies as a service unit and obtains a grant of tax exemption will, during its exemption period, be subject to a maximum tax rate of forty-five percent on fifty percent of its worldwide income, thereby being subject to an effective tax rate of twenty-two percent.

2. Taxes on Distributions. The tax treatment of the distribution of the accumulated earnings and profits of an IBE that is organized in Puerto Rico depends on the following three factors: (i) whether the distribution is a dividend or liquidating distribution, (ii) the source of the earnings being distributed, and (iii) the character and residence of the stockholder receiving the distribution. For purposes of this discussion, it is assumed that all of the accumulated earnings of an IBE represent income which has enjoyed the exemption afforded by the Incentive Act and which has been derived almost exclusively from sources outside of Puerto Rico.⁸⁵

If the stockholder of the IBE is a nonresident individual (i.e. not a resident of Puerto Rico) or a foreign (non-Puerto Rico) corporation and the

⁸⁴*Id.*

⁸⁵For purposes of this discussion it is assumed that an IBE's principal source of income will consist of interest income from loans made to nonresidents of Puerto Rico. Under the Puerto Rico source rules, such income is non-Puerto Rico source income. P.R. LAWS ANN. tit. 13, § 3119(a)(1) (1976). Note that this is in conflict with the requirement applicable to service units that eighty percent of the value of their services be generated from sources in Puerto Rico. See text accompanying *supra* note 84.

distribution consists of a dividend, the income being distributed would be considered non-Puerto Rico source income.⁸⁶ Accordingly, the dividend would not be subject to any Puerto Rico tax.⁸⁷ If the distribution is a distribution in liquidation, however, and the recipient is a corporation, the income being distributed would generally be subject to a withholding tax equal to ten percent.⁸⁸ This withholding tax could be reduced to four percent if certain investment requirements specified in the Incentives Act were satisfied by the IBE.⁸⁹ If the recipient is a United States citizen, the normal rules relating to the taxation of capital gains realized by residents of Puerto Rico would apply.⁹⁰ If, on the other hand, the recipient is a nonresident alien, the gross amount distributed would originally be subject to a withholding tax of twenty-nine percent.⁹¹ This withholding tax may be reduced to zero, however, if the recipient could establish that such distribution would not be subject to taxes (or that the Puerto Rico taxes could not be credited) in the jurisdiction of his residence.⁹²

If the stockholder is a Puerto Rico resident or a corporation organized in Puerto Rico, fifty percent of the earnings distributed as a dividend would be exempt from tax provided the IBE satisfied the investment requirements set forth in the Incentives Act.⁹³ The balance of the dividend distribution would be taxed at the normal rates applicable to individuals and corporations.⁹⁴ In the case of a liquidating distribution, no tax would be imposed on the income distributed if the IBE satisfies the above-mentioned investment requirements.⁹⁵

⁸⁶P.R. LAWS ANN. tit. 13, § 3119(a)(2)(A) (1976) provides that a dividend distributed by a Puerto Rico corporation will be considered non-Puerto Rico source income if, during the preceding three taxable years, the corporation derived less than 20% of its gross income from Puerto Rico sources.

⁸⁷P.R. LAWS ANN. tit. 13, §§ 3116(a)(1), 3212 and 3231(c) (1976) provide that a nonresident of Puerto Rico and a non-Puerto Rico corporation are subject to tax in Puerto Rico only with respect to income from Puerto Rico sources. It can be argued, however, that any dividend distributed to a corporate stockholder from earnings derived from an activity which enjoys partial tax exemption under the Incentives Act is subject to the 10% withholding tax imposed by P.R. LAWS ANN. tit. 13, § 255c(b) (Supp. 1981).

⁸⁸P.R. LAWS ANN. tit. 13, § 255c(b) (Supp. 1981). Under P.R. LAWS ANN. tit. 13, § 3119(a)(7)(A) (1976) distributions in liquidations by a Puerto Rico corporation are always considered Puerto Rico source income.

⁸⁹*Id.* § 255e(b) (Supp. 1981).

⁹⁰If the distributee held the stock of the distributing corporation more than six months, he would be subject to a maximum tax of 25% on the amount of the gain realized. P.R. LAWS ANN. tit. 13, § 3117(c)(2)(A) (1976).

⁹¹*Id.* § 3211(a)(1)(B) (1976).

⁹²*Id.* § 255e(a) (Supp. 1981).

⁹³*Id.* § 255c(a) (Supp. 1981).

⁹⁴Individuals are subject to progressive tax rates which range from approximately 10% to 68%. Corporations are subject to a maximum tax rate of 45%. P.R. LAWS ANN. tit. 13, §§ 3011, 3013, 3015 (1976). Corporations are entitled to deduct 85% of the amount received as a dividend from another Puerto Rico corporation. *Id.* § 3026(a) (1976).

⁹⁵P.R. LAWS ANN. tit. 13, § 255e (Supp. 1981).

**B. *An IBE Organized as a United States Corporation
or a Branch Thereof***

1. *Taxes on Operations.* For Puerto Rico income tax purposes, a corporation organized in the United States is considered a foreign corporation.⁹⁶ Accordingly, an IBE organized in the United States is subject to Puerto Rico income taxes only with respect to income from Puerto Rico sources.⁹⁷ As previously stated, in the case of an IBE holding a grant of tax exemption, only fifty percent of its income from Puerto Rico sources would be subject to tax during its exemption period. Since most of an IBE's income would come from sources outside Puerto Rico, it is likely that an IBE organized in the United States would pay little or no taxes in Puerto Rico.

2. *Taxes on Distributions.* Dividend and liquidating distributions to recipients who are nonresident individuals and foreign corporations would be exempt from Puerto Rico taxes as non-Puerto Rico source income, provided the IBE derived more than eighty percent of its income from non-Puerto Rico sources.⁹⁸

VI. Conclusion

With the enactment of the International Banking Center Regulatory Act, Puerto Rico has created a new haven in the Caribbean in which the international banking community can operate under a favorable and flexible tax and regulatory environment. In addition to the legal benefits provided by the Act, there are other intangible benefits which make Puerto Rico an attractive center from which to operate. These include a good geographical location, a strong and stable government with a long-standing tradition of democracy, an abundant supply of skilled labor, a highly sophisticated banking industry and a reliable network of telephone and telex communication.

⁹⁶*Id.* § 3411(a)(4) and (5) (1976).

⁹⁷*Id.* § 3231(c) (1976).

⁹⁸*Id.* § 3119(a)(2)(B) and (a)(7)(B) (1976).

